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Comments

A Statutory Proposal for the Regulation of Fairness Opinions in Corporate Control Transactions

I. INTRODUCTION

Investment bankers' fairness opinions are customarily included in virtually every type of corporate control transaction.[1] A fairness opinion is a document prepared by an investment banker, usually in the form of a brief letter,[2] which presents an opinion on the fairness or adequacy of the consideration which shareholders will receive in a proposed transaction.[3]

1. Investment bankers are asked to render fairness opinions in an endless variety of such transactions. *See, e.g.*, Herskowitz v. Nutri/System, Inc., 857 F.2d 179, 183 (3d Cir. 1988), *cert. denied*, 489 U.S. 1054 (1989) (leveraged buyout); Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1986), *rev'd*, 481 U.S. 69 (1987) (poison pill arrangement); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 271 (2d Cir. 1986) (lock-up option); Treadway Cos. v. Care Corp., 638 F.2d 357, 365 (2d Cir. 1980) (sale of treasury stock); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 694 (2d Cir. 1980) (tender offer); Denison Mines Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 821-22 (D. Del. 1974) (negotiated merger); Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66, 82 (E.D. N.Y. 1969) (freeze-out merger), *modified*, 478 F.2d 1281 (2d Cir. 1973); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 950-51 (Del. 1985) (selective self-tender offer); Weinberger v. UOP, Inc., 457 A.2d 701, 706 (Del. 1983) (cashout merger); MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1243 (Del. Ch. 1985) (purchase rights issue), *aff'd*, 506 A.2d 173 (Del. 1986); Kahn v. United States Sugar Corp., No. 7313 (Del. Ch. Dec. 10, 1985) (1985 WL 4449) (self tender), *reported in* 11 DEL. J. CORP. L. 908, 913 (1986); Kaplan v. Goldsamt, 380 A.2d 556, 561 (Del. Ch. 1977) (share repurchase).

2. Olson and Najjar, *Fairness for Whom? Fairness Opinions in LBOs and MBOs*, INSIGHT, Aug. 1989, at 31 ("[N]early all opinion letters are under [one and one-half] pages in length.").

3. *See, e.g.*, *Herskowitz*, 857 F.2d at 183 (bank issued "fairness opinion stating that the $7.16 a share price was fair to shareholders because company was worth between $6.50 and $8.50 a share"); *Dynamics Corp. of Am.*, 794 F.2d at 257 (fairness opinion considered tender offer "unfair"); *Unocal Corp.*, 493 A.2d at 950 (opinion that proposal was "wholly inadequate"); *MacAndrews & Forbes Holdings, Inc.*, 501 A.2d at 1243 (price offered was "grossly inadequate").

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Corporate directors have tremendous incentive to obtain fairness opinions. Fairness opinions are used to satisfy the fiduciary obligations of the directors to the shareholders.[4] Indeed, the landmark decision of *Smith v. Van Gorkom*[5] placed great emphasis on obtaining such an opinion in order for directors to satisfy their fiduciary duties.[6] Peculiarly difficult problems can arise regarding the directors' fiduciary duties when the directors have some personal stake in the transaction,[7] or where the directors are the purchasing party in a "going private" transaction.[8]

Reactions to fairness opinions have been varied. Some commentators recognize their potential for positive use.[9] Others are less optimistic. Fairness opinions have been criticized as being director-created machinations used to protect directors from liability,[10] and as expensive taxes on shareholders' returns.[11] This Comment analyzes many of the problems concerning fairness opinions, and proposes a statutory solution. Specifically, this

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4. Chazen, *Fairness from a Financial Point of View in Acquisitions of Public Companies: Is "Third Party Sale Value" the Appropriate Standard?*, 36 BUS. LAW. 1439, 1442 (1981). Courts will give weight to fairness opinions when the courts analyze whether directors have met their fiduciary obligations. *See* Cottle v. Storer Communication, Inc., 849 F.2d 570, 578 (11th Cir. 1988) (obtaining fairness opinion "weighs in favor of finding" that the directors satisfied their fiduciary duties); Tanzer Economic Assocs. Profit Sharing Plan v. Universal Food Specialties, Inc., 87 Misc. 2d 167, 178, 383 N.Y.S.2d 472, 481 (Sup. Ct. 1976) (detailed analysis of expert's evaluation not needed; no "palpable or gross undervaluation, which on its face would shock the conscience of the Court").

5. 488 A.2d 858 (Del. 1985).

6. *Id.* at 876-78.

7. For example, in situations involving a merger or a buyout where the directors/management will be retained at a higher compensation rate, or granted compensation incentives (such as stock options) by the new owner, definite conflicts exist.

8. *See* Olson and Najjar, *supra* note 2, at 22-23 (management buyouts (MBOs) present problems due to the informational superiority of management over "nonaffiliated shareholders," and the inherent conflicts of interest between management and the shareholders). *See infra* notes 57-59 and accompanying text.

9. Bebchuk and Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27, 52 (1989).

10. *Longstreth Says Federal, State Laws are Not Assuring Fairness in Buyouts*, 15 SEC. REG. & L. REP. (BNA) 1908, 1909 (1983) (fairness opinions are "boiler-plated pass keys" which protect management from legal challenges from shareholders).

11. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1453 (1985). Professor Fischel argues that shareholders inevitably pay for a management-sympathetic expert who will opine as to the fairness of the price. The cost of such an opinion is a "judicially imposed tax on fundamental corporate changes" which, in actuality, results in lower returns to shareholders. *Id.*

Comment first addresses the discretion given to investment bankers in determining a "fair" or "adequate" price. Next, this Comment explores the conflict of interest problems between investment bankers and their clients, as well as the inherent conflicts between management and shareholders in such transactions. Finally, a statutory solution is proposed in an attempt to resolve some of the potential problems and create a more shareholder-useful document.

II. THE DANGERS OF DISCRETION IN FAIRNESS OPINIONS

At the outset, it should be noted that fairness opinions are just that: *opinions*[12] as to the fairness or adequacy of an offer. As opinions, investment bankers have great discretion in determining what price is "fair."[13] Considering the extreme variety of methods available to value a company and determine a fair price, widely varying estimates could be completely justified.[14]

One significant problem with such opinions is the definitional problem[15] of fair price.[16] Courts generally have not specified the proper definition of fair price,[17] or have specifically refused to define fair price.[18] There have

12. Fairness opinions are quite different from any type of *legal* opinion, letter, or communication. Such a letter or communication will generally give advice to shareholders or members of a special committee as to any legal problems or legal obligations under federal or state law, but will not opine as to the financial adequacy or inadequacy of any offer. *See* Simpson, *The Emerging Role of the Special Committee—Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest*, 43 BUS. LAW. 665, 678-81 (1988) (advising retention of independent legal advisors by a special committee).

13. Bebchuk and Kahan, *supra* note 9, at 29.

14. *See, e.g.*, Joseph v. Shell Oil Co., 482 A.2d 335 (Del. Ch. 1984). The investment bankers involved, Morgan Stanley and Goldman-Sachs, arrived at different estimates of the value of the minority shares, $53 and $80-$85 respectively. *Id.* at 339.

15. Bebchuk and Kahan, *supra* note 9, at 30.

16. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983). The *Weinberger* court noted that fair price "relates to the financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." *Id.* The court further recognized that price can be the "preponderant consideration" in such a transaction. *Id.*

17. *See, e.g.*, Kahn v. United States Sugar Corp., No. 7313 (Del. Ch. Dec. 10, 1985) (Westlaw), *reported in* 11 DEL. J. CORP. L. 908, 925 (1986) (court could not in

been a multitude of definitions suggested by various authorities.[19] Moreover, the "appropriateness of any definition also might depend on the context of the acquisition in question."[20] Where there are several competing acquirors, the appropriate definition may be the auction price.[21] If the acquisition is hostile, as in a take-out merger, the opinion could be crafted in terms of obtaining a better price.[22] If the acquisition is friendly, the opinion will likely contain a range of values in which the board can accept an offer and still satisfy its fiduciary obligations to shareholders.[23] Tying the definition of fair price to the type of transaction, and its nature, however, "poses the

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any "rational way" determine which definition of value was superior).

18. *See, e.g.*, Joseph v. Shell Oil Co., 482 A.2d 335, 344 (Del. Ch. 1984) (court refused to substitute its judgment of fair price for the shareholders).

19. One such value definition is the auction price determined by the highest bidder in the sale of the corporation. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986); *see also* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 869 (1981) (proper role for management is to seek highest price for shareholders).

Another definition is the price yielded in "arm's-length" negotiations to reach a bargain. *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939); *see also* Nathan & Shapiro, *Legal Standard of Fairness of Merger Terms Under Delaware Law*, 2 DEL. J. CORP. L. 44, 48 (1977) (knowledgeable, rational buyer purchasing in arm's length negotiations).

A third definition is that value of a company which is its isolated, independent value as if it did not engage in the proposed transaction, or any other. *See* Bebchuk & Kahan, *supra* note 9, at 31.

Net asset value can be used as the fair price. *See, e.g.*, E.I. du Pont de Nemours & Co. v. Collins, 432 U.S. 46, 54 (1977) ("'[A]sset value' is . . . much more applicable to investment companies than to other corporate entities.").

Additionally, courts have recognized that weighted averages of several value definitions lead to a plausible approximation of fair value. *See, e.g.*, Piemonte v. New Boston Garden Corp., 377 Mass. 719, 733, 387 N.E.2d 1145, 1153 (1979) (use of Delaware block approach in appraisal rights action); Endicott Johnson Corp. v. Bade, 37 N.Y.2d 585, 587, 338 N.E.2d 614, 616, 376 N.Y.S.2d 103, 106 (1975) (net asset value, investment value, and market value considered).

20. Bebchuk & Kahan, *supra* note 9, at 32; Chazen, *supra* note 4, at 1443-48.

21. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d at 182.

22. Weiss, *The Law of Take Out Mergers: Weinberger v. UOP, Inc. Ushers in Phase Six*, 4 CARDOZO L. REV. 245, 256 (1983).

23. Bebchuk & Kahan, *supra* note 9, at 33; Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 120-21 (1986). Additionally, non-acquisition transactions can have different measures of fair price as well. Bebchuk & Kahan, *supra* note 9, at 33 n.41.

danger that banks will manipulate definitions to favor management."[24] Investment bankers generally have no legal restrictions on which definitions they choose.[25] The only restrictions are imposed by management,[26] and such restrictions arguably pose an even greater danger of management manipulating the outcome of the fairness opinion.

Even if "fair price" is somehow defined, there is still incredible discretion in the mode of analysis used to achieve the result. Cases abound describing the wide variety of assumptions, simplifications, and methodologies used to determine fair price.[27] At best, such estimates have been recognized as necessarily imprecise and subjective.[28] In valuing a company, several general assumptions must be made. Yet, even if different analysts agree on virtually every assumption, a slight difference in one estimate (assuming it is a legitimate difference) can produce widely disparate results.[29] In defining

24. Bebchuk & Kahan, *supra* note 9, at 31 n.26.

25. *See supra* notes 17-18 and accompanying text.

26. *See* Comment, *Regulation of Leveraged Buyouts to Protect the Public Shareholder and Enhance the Corporate Image*, 35 CATH. U.L. REV. 489, 533 (1986) ("[A]ccuracy of financial opinions can be skewed by the limitations that the control group often places on the investment banker's review."); *see also* Longstreth, *New Controls for Leveraged Buyouts*, N. Y. Times, Nov. 6, 1983, § 3, at 3, col. 2 (managers request investment bankers to ignore liquidation value).

27. *See* Kahn v. United States Sugar Corp., No. 7313 (Del. Ch. Dec. 10, 1985) (Westlaw), *reported in* 11 DEL. J. CORP. L. 908, 919 (assumptions used by various experts differed; all contained justifiable bases for their selections); Piemonte v. New Boston Garden Corp., 377 Mass. 719, 733, 387 N.E.2d 1145, 1153 (1979) (net asset value measurement used); *see also* Fischel, *supra* note 11, at 1452 (in a discounted cash flow projection, "[b]y assuming sufficiently high future earnings, or a sufficiently low discount rate, it is possible to come up with just about anything"). *See generally* R. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS § 11 (1989) (discussing the various valuation techniques presently in use, including discounted cash flow value, asset value, book value, prior purchase or sale value, and discounts from market value); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1165-67 (1981) (efficient capital market hypothesis indicates that share price in an efficient market is true firm value).

28. Radol v. Thomas, 534 F. Supp. 1302, 1305 (S.D. Ohio 1982) (methods used in calculating value of oil reserves were "necessarily imprecise", and some assumptions could be characterized as "at best optimistic and at worst inaccurate"). *See also* Comment, *supra* note 26, at 534; R. HAMILTON, *supra* note 27, § 11.03, at 230 (valuation "not an exact science" with even some experts making suspect conclusions).

29. This can be briefly illustrated by the following example of a capitalization of earnings analysis:

> Assume that the impossible happens and two analysts agree that a company will have profits of $100,000 in each coming year, but one analyst

fair price, investment bankers have no legal restrictions on their modes of analysis.[30] Again, the only restrictions are imposed by management. Thus, management can specify which assumptions can and cannot be used,[31] or may selectively withhold certain types of information about the company, restricting an investment banker's ability to make an adequate valuation.[32] Both the investment banker's unrestricted discretion and management's potential ability to tailor the information used pose significant risks of

> determines that the proper discount rate is eight percent a year while the other believes the proper rate is ten percent a year. The two percent difference in the discount rates will result in estimates that diverge by twenty-five percent. The first analyst will estimate the company's value at $1,250,000, while the second analyst will value it at $1,000,000. Of course, if the analysts do not agree on the amount of future profits, their estimates might be even further apart. For example, if the first analyst thinks profits will grow at an annual rate of four percent, and the second analyst thinks they will grow at only two percent, their respective estimates will be $2,500,000 and $1,250,000. These analyses—both legitimate under prevailing standards—would produce very different conclusions about whether a price of, say, $2,000,000 is fair.

Bebchuk & Kahan, *supra* note 9, at 35-36 (footnotes omitted).

30. No cases were found where the law in a particular jurisdiction restricted an investment bank to certain valuation methods. To the contrary, the Delaware Supreme Court has indicated that fair price can be determined by a wide variety of methods acceptable in the industry. *Weinberger*, 457 A.2d at 712.

31. The Securities and Exchange Commission (SEC) has broached this issue in its review of fairness opinions under Rule 13e-3, 17 C.F.R. § 240.13e-3 (1989). The SEC is considering whether

> it may be misleading for a company or affiliate to opine that a transaction is fair and purport to rely on an opinion when there are limitations placed on the procedures used by the investment banking firm—such as restrictions on the firm's ability to consider values obtained in recent comparable transactions, or reliance solely on the publicly available information.

Leveraged Buyouts and Corporate Debt: Hearing Before the Committee on Finance, 101st Cong., 1st Sess. 149 (1989) (prepared statement of David S. Ruder, Chairman of the SEC).

32. *See* Interpretive Release Relating to Proxy Rules, Securities Exchange Act Release No. 16,833, 45 Fed. Reg. 36,374 (1980) (Division of Corporation Finance expressing concern of the need for disclosure of any "limited access to the type of information necessary" to an expert for the formulation of a valuation opinion concerning SEC Rule 14a-9).

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improper valuation[33] or improper management influence[34] on fairness opinions.

The discretion given to investment bankers regarding their fair price evaluations is disturbing. Moreover, many fairness opinions do not disclose what valuation methods were used,[35] or whether there were limitations placed on the availability of information.[36] Arguably, some legal control is necessary either in regulating the definition or measurement methods used, or in requiring adequate disclosure of the definitions or methodologies used.[37] Proposed solutions are considered in the final section of this Comment.[38]

III. CONFLICTS OF INTEREST

The very nature of the relationship between investment bankers and the individuals who hire and pay them (usually corporate officers or directors) creates serious conflicts of interest.[39] These conflicts exist in ordinary third party acquisitions, but become even more pronounced in leveraged buyouts with management participation.

33. If management refuses to disclose certain information regarding key company assets, the valuation is unlikely to be accurate. *See, e.g.*, Joseph v. Shell Oil Co., 482 A.2d 335, 341 (Del. 1984) (critical information on oil reserves of an oil exploration company withheld from an investment banker; it would "defy reason" to conclude a proper valuation was possible).

34. Management could conceivably tailor key information to suit their objectives, that is, legally manipulating financial statements or other records. *See Longstreth Says Federal, State Laws are Not Assuring Fairness in Buyouts*, *supra* note 10, at 1910 (discussing potential management manipulation of company books and filings using selective application of accounting principles, in order to discourage potential bidders). Hypothetically, managers could even "create" information to provide the basis for favorable opinions.

35. Olson & Najjar, *supra* note 2, at 30-31.

36. *Id.*

37. There could be potentially insurmountable problems with either statutorily or judicially specifying exact fair price definitions or measurement methods, due to the diversity of these concepts. *See supra* notes 19-24 and accompanying text. This Comment suggests a disclosure approach to such concepts. *See infra* notes 89-90 and accompanying text; *see also* Bebchuk & Kahan, *supra* note 9, at 46 (recommending banks disclose fair price definitions in their opinions).

38. *See infra* notes 89-90 and accompanying text.

39. *See* Bebchuk & Kahan, *supra* note 9, at 37; Note, *supra* note 23, at 128; *see generally* Wander, *Special Problems of Acquisition Disclosure: Investment Bankers' Reports and Conflicts of Interest*, SEVENTH ANNUAL INSTITUTE ON SECURITIES REGULATION 157, 175 (1976).

The compensation contracts under which investment banks are hired create conflicts of interest in virtually any transaction. Although banks occasionally receive fixed fees for their opinions,[40] frequently such fees are, at least in part, contingent on the consummation of the deal,[41] rejection of a raider,[42] recruitment of a "friendly" acquiror,[43] or on other events.[44] Of particular concern are fees contingent on the consummation of a transaction; investment bankers have incredible incentive to give favorable opinions in order for a deal to fly.[45] By favoring a deal, investment banks can "earn contingent fees if they characterize management proposals as fair or they can garner modest fees if deals collapse as a result of their [unfavorable] opinions."[46] Such fee structures give investment banks incentive to slant their opinions favorably toward the officers' or directors' interests.[47] Moreover, even fixed fee arrangements are not immune from conflicts. Simply put, the more favorable the opinion, the more work will be generated for the investment bank.[48] Investment banks which render fairness opinions often perform other duties for the officers or directors.[49] By helping a deal go through, investment bankers generate larger fees due to the volume of work required for a successful merger, acquisition, or other transaction.

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40. *See, e.g.*, *Weinberger*, 457 A.2d at 706 (fixed fee of $150,000); Bebchuk & Kahan, *supra* note 9, at 38.

41. Bebchuk & Kahan, *supra* note 9, at 38.

42. *See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1986) (Smith Barney to receive bonus if Dynamics lost the proxy battle), *rev'd*, 481 U.S. 69 (1987).

43. *See, e.g.*, Rodal v. Thomas, 534 F. Supp. 1302, 1314-15 (S.D. Ohio 1982) (contingent fee received if Marathon Oil Co. merged with "white knight" United States Steel Corp.).

44. Investment banks can garner extra fees if their opinions are made public. *See* Herskowitz v. Nutri/System, Inc., 857 F.2d 179, 183 (3d Cir. 1988), *cert. denied*, 489 U.S. 1054 (1989); Anderson v. Boothe, 103 F.R.D. 430, 435 (D. Minn. 1984).

45. Bebchuk & Kahan, *supra* note 9, at 39.

46. *Id.* (footnote omitted).

47. *Id.* at 39-40. *See* McGough, *Fairness for Hire*, FORBES MAGAZINE, July 29, 1985, at 52 (bankers would be "kissing their [contingent] fees good-bye if they didn't capitulate to the board").

48. Bebchuk & Kahan, *supra* note 9, at 40.

49. *See, e.g.*, *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 885 (6th Cir. 1986) ("[C]ommittee of outside directors employed as its advisor the investment banker that was in the process of negotiating management's buyout proposal . . . ."); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1267-68 (Del. 1989) (investment banker hired by special committee had already "worked with management on the proposed restructuring for over 500 hours" before the Special Committee retained him as financial adviser).

Other factors also create conflicts of interest between investment banks and officers or directors. Investment banks have incentives to write opinions that attract future clients[50]. And, because corporate officers or directors select the banks, banks create business by satisfying corporate officers or directors.[51] This is a great incentive to craft fairness opinions according to directors' wishes. Additionally, in certain circumstances, investment bankers may personally know the corporate officers that hire them,[52] or may have worked with them in the past,[53] or may even be assisting them in other aspects of the transaction for which the bank will produce an opinion.[54] These relationships can potentially "lead bankers to give undue weight to managers' goals, at the cost of shareholder interests."[55]

Conflict of interest concerns increase in situations involving management participatory leveraged buyouts (MBOs). In simple terms, a management-led buyout involves borrowing funds from lenders to purchase a company. The company's assets are then used as collateral for the loans and the equity of the "new" company is held, at least in part, by management.[56] In MBOs, management has serious conflicts of interest with the shareholders' interests they purport to represent.[57] They have inherent advantages over shareholders

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50. Bebchuk & Kahan, *supra* note 9, at 41.

51. *Id.*

52. *See Weinberger*, 457 A.2d at 706 (the investment banker whose firm prepared the opinion was a financial adviser to UOP for many years).

53. "Often, a banker has a past relationship and prospects for future business with a company; sometimes a bank has even structured the deal it is supposed to judge." McGough, *supra* note 47, at 52; *see also* Cottle v. Storer Communication, Inc., 849 F.2d 570, 577 (11th Cir. 1988) (investment banker had prior working relationship with defendant).

54. *Cottle*, 849 F.2d at 577.

55. Bebchuk & Kahan, *supra* note 9, at 43.

56. One commentator has described a management buyout as follows:

> A management buyout (MBO) is a species within the corporate genus of leveraged buyout (LBO). The typical LBO involves four distinct transactions: (1) the formation of a new company to acquire all the assets or shares of an existing operating company or to acquire the assets of an operating division of a multi-division company; (2) the cash purchase of those assets or shares and a distribution to public shareholders of cash or a combination of cash and senior securities; (3) loans to the new company from banks and other institutional lenders to furnish the cash; (4) the distribution of the new company's equity to members of its management or to its various lenders.

DeMott, *Directors' Duties in Management Buyouts and Leveraged Recapitalizations,* 49 OHIO ST. L.J. 517, 519 (1988).

57. *See* Note, *supra* note 23, at 121 n.12 (problem "particularly acute in going

with regard to company information[58] and their own "personal" projections and estimates used to secure financing.[59] Directors still owe a fiduciary duty to shareholders in these types of transactions, but the business judgment rule can protect directors against breach of fiduciary duty charges when they rely on an investment banker's fairness opinion.[60] Thus, the fiduciary duties involving fairness of the transaction can be resolved by resorting to the opinion of an "impartial" financial advisor.[61]

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private transactions involving management"); *see generally* Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1367-68 (1978) (proposing to ban going private transactions under select circumstances); DeMott, *supra* note 56, at 539-54 (analyzing directors' duties of good faith and loyalty in MBOs and other leveraged buyouts).

58. Olson & Najjar, *supra* note 2, at 27-28.

59. A fellow student author has noted this advantage. These private calculations

> are the real figures, which are kept from the corporation's outside shareholders and seem to be "management's private preserve." These real figures, which go beyond the assets and liabilities listed on the balance sheet, give "meaning and synthesis to otherwise discrete economic units." For example, in the summer of 1983, David Mahoney, then chairman and chief executive officer of Norton Simon, Inc., made an unsuccessful leveraged buyout bid for Norton Simon, Inc. Not only was he *not* required to reveal the sources of his financing, but he was *not* required to share with the outside shareholders the internal projection figures he had calculated to obtain financing commitments from lenders.

Comment, *supra* note 26, at 535-36 (footnotes omitted) (emphasis added).

60. *See, e.g.*, Cottle v. Storer Communication, Inc., 849 F.2d 570, 578 (11th Cir. 1988) (board consulting an investment banker "weighs in favor" of finding a lack of abuse of discretion, where such abuse would remove the protection of the business judgment rule); Treadway Cos. v. Care Corp., 638 F.2d 357, 384 (2d Cir. 1980) (exercise of judgment in good faith upheld where directors engaged an investment banker to negotiate and help evaluate merger proposals); Horwitz v. Southwest Forest Indus., Inc., 604 F. Supp. 1130, 1134-35 (D. Nev. 1985) (defendants protected by the business judgment rule where advice regarding poison pill warrants was obtained from investment banks and counsel); Treco Inc. v. Land of Lincoln Sav. & Loan, 572 F. Supp. 1455, 1460 (N.D. Ill. 1983) (directors exercised reasonable care in defensive tactics by seeking advice of counsel and investment bankers); Anaconda Co. v. Crane Co., 411 F. Supp. 1210, 1215 (S.D.N.Y. 1975) (investment banker's opinion that offered price was too low justified defenses); Bebchuk & Kahan, *supra* note 9, at 28; Note, *supra* note 23, at 120-21.

61. This presumes that a fairness opinion qualifies as "advice." Note, however, that such an opinion is one factor in demonstrating a director's good faith and proper exercise of due care. Directors' reliance on poorly prepared opinions can cause a court to find that such directors have breached their fiduciary duties. *See, e.g.*, Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 275-76 (2d Cir. 1986) (due care requires a director to evaluate "material information" and oversee "outside advice on

Therefore, fairness opinions play an important role in MBOs. The Securities and Exchange Commission(SEC), in Rule 13e-3,[62] recognized the inherent disadvantage to shareholders who are requested to sell their interests to the corporation's management. The rule "seeks to provide shareholders with the information they need to assess the fairness of the transaction and to pursue remedies under state law."[63] The issuers and affiliates in "going private" transactions must provide "material information to the holders of the class of equity securities that is the subject of the transaction."[64] Schedule 13E-3[65] provides a list of items that must be disclosed in order to comply with the rule. Item 9 of the Schedule requires the issuer or affiliate to disclose any "reports, opinions or appraisals" received from an outside party which relate to the regulated transaction.[66] Although a fairness opinion is *not* mandated by the Rule, there must be "disclosure of the qualifications of the adviser giving the opinion, the terms of the engagement, potential conflicts of interest (including manner of compensation), the procedures followed, and the basis for and the methods of arriving at the findings contained in the opinion."[67]

The SEC obviously recognizes the impact, and the potential for misuse, of a fairness opinion in a going private transaction. These opinions are particularly important where they serve to shield management from charges involving breach of fiduciary duty.[68] The danger involved is that shareholders or independent directors will rely on poorly prepared opinions.[69] The misinformation in a poorly prepared opinion could cause a shareholder or director to vote against, or in favor, of a transaction which may or may not be in his or her best interests. Also, if management places limitations on the procedures used by the investment banker, such a fairness opinion could be

which he might rely").

62. 17 C.F.R. § 240.13e-3 (1989).

63. *Leveraged Buyouts and Corporate Debt: Hearing Before the Committee on Finance*, *supra* note 31, at 137.

64. *Id.* at 138.

65. 17 C.F.R. § 240.13e-100 (1989).

66. *Id.*

67. *Id.*

68. *See supra* notes 60-61 and accompanying text.

69. *See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1986) ("How the fairness of the tender offer [can] be determined without any consideration of the fairness of the offer price is mystifying."); *Hanson Trust PLC*, 781 F.2d at 275 (conclusory opinion of investment banker; banker did not investigate range of fair values); Weinberger v. UOP, Inc., 457 A.2d at 712 (court noted the "rather cursory preparation" of the fairness opinion, with the "price left blank" on the draft brought to the directors' meeting).

slanted toward management's objectives.[70] Thus, if management has advantages to gain from the consummation of the transaction,[71] it would certainly be in management's best interests to produce a favorable opinion. Similarly, if management specifies the use of certain valuation techniques, and not others, the opinions could be of marginal use to directors or shareholders.[72]

Shareholders, as well as courts, may place significant and unfounded weight on misleading fairness opinions.[73] In addition to being used to persuade shareholders to tender their shares or approve a transaction,[74] fairness opinions are used to satisfy director's and officer's fiduciary obligations. In the context of MBOs, the potential conflicts of interest always inherent between managers and investment bankers[75] become heightened by conflicts of interest between management and nonaffiliated shareholders.[76]

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70. *See supra* notes 31-34 and accompanying text.

71. Even if management is not the purchasing party, a new corporate owner could grant management incentives such as higher compensation, long-term employment contracts, or stock option bonus plans, in order to gain management's approval of the transaction.

72. *Leveraged Buyouts and Corporate Debt: Hearing Before the Committee on Finance*, *supra* note 31, at 149.

73. *See, e.g.*, Denison Mines Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 821 (D. Del. 1974) ("[I]mpact of the reference to Lehman Brothers' [fairness] opinion on a substantial number of stockholders would be difficult to overestimate."); Joseph v. Shell Oil Co., 482 A.2d 335, 341 (Del. Ch. 1984) ("[A] primary purpose of the fairness opinion . . . was to convince stockholders to whom the tender offer was to be made that the price offered was fair. To believe otherwise is unrealistic."); Note, *supra* note 23, at 123.

74. *See supra* note 69.

75. As the court in *Weinberger* noted:

> When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain. . . . The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness . . . .

Weinberger, 457 A.2d at 710 (citations omitted). This language is particularly appropriate where management stands as protector of the shareholders' interests as well as potential purchaser of their interests.

76. *See supra* notes 56-61 and accompanying text.

IV. A STATUTORY PROPOSAL

In the past, commentators have recommended different judicial approaches to minimize reliance on questionable fairness opinions.[77] Additionally, the commentators have suggested revisions regarding the preparation of these opinions to improve their usefulness.[78] This Comment proposes a more direct solution: statutory regulation of the selection of fairness opinion preparers, and regulation of the actual preparation of the opinions. This regulation is a suggested state law development which addresses the questionable independence of investment banks, and the fiduciary obligations of management regarding these opinions.[79]

The statute which follows was partially developed with principles borrowed from SEC Rule 13e-3[80] and Form 13E-3.[81] The statute attempts, however, to place mandatory procedural requirements on investment bankers in their preparation and disclosure of such opinions, and places explicit management restrictions that seek to negate certain conflicts of interest between management and the bankers.

Section one begins with the implicit recognition that its provisions will only apply if a fairness opinion or other similar valuation estimate is rendered in the transaction. Thus, it codifies the "negative" rule of law in *Smith v. Van Gorkom*:[82] fairness opinions are not explicitly required in corporate control transactions.[83]

Section two specifies the procedure for selecting an investment banker. Deference is given to the role of a special committee composed of indepen-

77. Bebchuk & Kahan, *supra* note 9, at 46-53; Note, *supra* note 23, at 132.

78. Olson & Najjar, *supra* note 2, at 31-32.

79. David S. Ruder, former Chairman of the Securities and Exchange Commission, has suggested that state fiduciary concepts are somewhat inadequate in the area of fairness opinions and the conduct desirable in their preparation. *See Management Buyouts: Hearing Before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce*, 100th Cong., 2d Sess. 63 (1988). One member of the subcommittee even suggested statutory prohibitions which would prevent investment bankers from representing shareholders and management in management buyouts. *Id.* at 87 (comments of the Honorable Edward Markey, Chairman of the Subcommittee on Telecommunications and Finance).

80. 17 C.F.R. § 240.13e-3 (1989).

81. 17 C.F.R. § 240.13e-100 (1989).

82. 488 A.2d 858 (Del. 1985).

83. *Id.* at 876 ("[N]or do we state that fairness opinions by independent investment bankers are required as a matter of law.").

dent or disinterested directors.[84] Such a committee should select the investment banker, and set the compensation fee.[85]

Section three mandates certain aspects of the investment banker selection process, and prohibits contingent fees. Contingent fee prohibitions are designed to guard against the almost overwhelming incentive to help consummate deals.[86] Certain investment bankers are prohibited from rendering a fairness opinion, based on any present engagements or work being performed by such investment banks.[87] Finally, there is an additional requirement which prohibits management from placing restrictions on the types of valuation techniques or measurement procedures used in the fairness opinion.[88]

Section four applies specifically to investment bankers. This section mandates disclosure of the definitions of fair price used. Moreover, there must be adequate explanation of the measurement assumption and valuation techniques such that a "reasonable" shareholder faced with a decision on the transaction at issue could adequately comprehend and be assisted by such disclosure.[89] Such opinion must specifically state the reliance placed on

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84. *See* Simpson, *supra* note 12, at 678.

85. *Id.* at 680. The committee should retain a financial adviser, who should possess adequate expertise and should be free of any "actual" conflicts of interest. *Id.*

86. Members of the Special Committee should seek to neutralize any potential conflicts of interest between managers and the investment bankers. *Id.* A prohibition on contingent fees helps neutralize such conflicts. See *supra* notes 44-47 and accompanying text which discuss problems raised by contingent fee arrangements; *see also* CODE OF PROFESSIONAL ETHICS § 302, Rule 302.01 (American Institute of Certified Public Accountants 1988) (noting that auditors certifying management's financial statements are prohibited from being compensated by contingent fees).

87. Additional costs are incurred by such a requirement: the cost of hiring a second investment banker, and the costs in time for an unfamiliar party to make an evaluation. Note, *supra* note 23, at 133 n.81. Such increased costs are arguably needed to develop a more neutral opinion. Bebchuk & Kahan, *supra* note 9, at 50. However, such costs can be considered "trivial in relation to the amounts involved in a transaction as a whole." *Id.* at 51.

88. Such prohibitions are designed to guard against the shareholders and Special Committee from relying on inaccurate or poorly prepared opinions due to managements' failure to cooperate. *See* Joseph v. Shell Oil Co., 482 A.2d 335, 341 (Del. Ch. 1984); see also *supra* notes 31-34 and accompanying text regarding the dangers of limited access to necessary valuation information.

89. Such a standard is not meant to require a detailed disclosure of all the precise intricacies and methodologies used by the investment banker. A summary explanation of the definition of fair price used, as well as general disclosure of the type of analysis performed, phrased in "plain English" for the benefit of shareholders, however, would conceivably assist shareholders in such a decision. *See* Bebchuk & Kahan, *supra* note 9, at 46 (advocating banker disclosure of fair price definition used). Full disclosure

Shareholder Protection Proposal

management's information and figures, and the extent of any independent verification of such information.[90]

Finally, section five specifically provides for civil liability for directors in sections two and three. Directors' reliance on such opinions can be used to satisfy fiduciary duties, so long as the directors have complied with the statutory requirements.[91] Courts can fill in the gaps in the statute, however, by holding directors liable for poorly prepared opinions in which the directors' negligently, or purposefully, provided erroneous information to the banker.[92] Moreover, directors should still have an obligation to study fairness opinions before approving or rejecting a transaction in reliance upon it.[93]

Section five also provides for potential civil liability for investment bankers. Failure to follow the procedures outlined in the statute will breach a fiduciary duty owed by investment bankers to those who rely on their opinions.[94] Tort law principles could be applied to hold the investment banker liable for the pecuniary loss suffered by the shareholders, who would

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of measurement techniques could also indicate which analyses the banker has, and perhaps more importantly, has *not* performed. *See* Note, *supra* note 23, at 137-38 (investment bankers generally use discounted cash flow analysis, comparable acquisition analysis, similar company comparison, and liquidation analysis); *Longstreth, Now Private Citizen, Calls for Reform in Leveraged Buyouts*, 16 Sec. Reg. & L. Rep. (BNA) 641, 641 (1984) (criticizing banks' failure to use comparable acquisition analysis and liquidation value).

90. Such disclosure of the degree of reliance on management's figures should help to prevent shareholders and Special Committee members from placing undue weight on opinions relying heavily on non-verified management supplied information. Since such an opinion would be of little value, the Special Committee should contractually insist on a comfortable level of verification.

91. Thus, the statute attempts to provide a general roadmap for the directors' good faith and loyalty objectives.

92. *See* Note, *supra* note 23, at 133. *See also* Joseph v. Shell Oil Co., 482 A.2d 335, 341 (Del. Ch. 1984) (directors breached their fiduciary duties by failing to provide banker with essential information).

Moreover, this provision implicitly recognizes that persons other than the Special Committee will rely on the opinion. *See* Wander, *supra* note 39, at 158 (fairness opinions likely to influence shareholders' votes).

93. *See* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 275 (2d Cir. 1986) (duty of good faith violated by directors not examining opinion on which they relied). Moreover, directors may, in certain transactions, be better equipped to form an opinion as to a transactions fairness than an investment banker. *See* Smith v. Van Gorkom, 488 A.2d 858, 876 (Del. 1985); Note, *supra* note 23, at 135 n.89.

94. *See* Note, *The Standard of Care Required of an Investment Banker to Minority Shareholders in a Cash-out Merger: Weinberger v. UOP*, 8 DEL. J. CORP. L. 98, 119 (1983) (advocating fiduciary duty owed to shareholders when an investment bank renders a fairness opinion).

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be presumed to rely on the information contained in the opinion.[95] Bankers would not be liable, however, for misleading opinions based on information erroneously received. Nonetheless, courts should also hold bankers liable under a negligence standard for failing to exercise reasonable care "in accordance with standards of the investment banking profession" when supplying an opinion complying with the statute.[96]

The following statute is constructed with reference to the Missouri Corporation Statutes.

> 351.456. DISCLOSURE OF INFORMATION REGARDING VALUATION OR FAIRNESS ESTIMATES- PROCEDURE FOR SELECTING THIRD PARTY VALUER, REQUIRED DISCLOSURE, PROHIBITIONS AND RESTRICTIONS.
>
> 1. In any transaction involving a control share acquisition, or other transaction involving the purchase, repurchase, offer to sell, or offer to purchase stock of an issuer from the issuer or issuer's shareholders, the issuer or any affiliate shall disclose to the board of directors and security holders any report, opinion (other than an opinion of counsel) or appraisal from an outside party which is related to the control share acquisition, purchase, repurchase, offer to sell, or offer to purchase securities of an issuer from the issuer or issuer's shareholders. Such reports include, but are not limited to, reports, opinions, or appraisals relating to the fairness of the consideration to be offered to shareholders of the class of securities subject to the aforementioned transaction, of the fairness of such transaction to the issuer or affiliate, or to security holders who are not affiliates.[97]
>
> 2. The outside party who prepares such report, opinion, or appraisal shall be selected by a committee composed of no fewer that three disinterested directors. If three disinterested directors are unavailable, a committee composed of fewer than three may be formed for such purpose. If there are no disinterested directors, a committee of disinterested shareholders shall be formed for such purpose. Such committee shall be charged with negotiating and approving such engagement contract, including compensation fee.

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95. *See* RESTATEMENT (SECOND) OF TORTS, § 552 (1977); Note, *supra* note 23, at 136.

96. *See* Note, *supra* note 23, at 137-39 (advocating the establishment of acceptable standards of valuation for the investment banking industry). Liability under this standard would follow along the same path as negligence liability in the accounting profession, including the defense of due diligence. *Id.* This proposal would significantly expand liability beyond simply complying with the terms of the statute, by "filling in" the definition requirements of § 4(1) of the statute, and the "reasonable shareholder" requirements of § 4(2).

97. This text is adopted from SEC Form 13E-3, 17 C.F.R. § 240.13e-100 (1989).

3. The committee charged with selecting the outside party shall:

(1) be prohibited from setting as a fee any amount contingent on the outcome of the acquisition, purchase, repurchase, or sale of the securities subject to the transaction;

(2) be prohibited from selecting any outside party significantly involved in any aspect of the current acquisition, purchase, repurchase, offer to sell, or offer to purchase;

(3) be prohibited from restricting such outside party to selective valuation techniques or measurement procedures in such report, opinion, or appraisal.

4. Such report, opinion, or appraisal provided by the outside party shall:

(1) disclose the definitions of any standards used in evaluating the transaction at issue, or consideration received by any party to the transaction;

(2) explain any valuation assumptions or procedures used such that a reasonable shareholder faced with a decision on the transaction at issue, could reasonably comprehend such assumptions and procedures and be assisted by their disclosure;

(3) disclose the degree of reliance placed upon information and disclosures provided by the issuer's officers, directors, or other affiliates, and the extent, if any, of any independent verification of such information.

5. In addition to penalties provided under this chapter, this section recognizes that a civil cause of action may arise for failure to reasonably comply with the provisions and procedures herein.

V. CONCLUSION

The purpose of this Comment has been to discuss the problems inherent in the preparation and disclosure of fairness opinions and to submit a statutory proposal to deal with these problems.

The problems in fairness opinions originate from both the investment bankers who prepare them, and from the managers who hire the bankers. Investment bankers often have unbridled discretion in defining fair price,[98] and in the measurement procedures used for the selected definition.[99] When management specifies certain definitions, or specifies the use of only certain information or valuation techniques,[100] the danger of unbridled discretion is replaced with the inevitable danger of misleading, management-slanted

98. *See supra* notes 15-26 and accompanying text.

99. *See supra* notes 27-34 and accompanying text.

100. *See supra* note 31.

opinions.[101] Moreover, the conflicts of interest that exist between investment bankers and managers,[102] especially conflicts related to contingent fee arrangements,[103] further discount the value of such opinions. In MBOs, these conflicts of interest heighten the potential for misuse and undue reliance on such opinions.[104]

The proposed statute is one attempt to solve the problems inherent in fairness opinions. The statute cannot, and does not, seek to resolve all the problems with fairness opinions,[105] nor deal with all conflict of interest questions.[106] The overall goal of the proposed statute is to regulate the preparation and disclosure of such opinions. Most importantly, the statute would contribute to the development of a document that could be relied upon by *shareholders*, as well as by members of a special committee charged with evaluating the merits of the proposal, as a means of evaluating the corporate control transaction.[107] The resulting document can also be used by courts in assessing, with greater confidence, whether directors have met their fiduciary duties to the corporation and its security holders.[108]

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101. *See supra* notes 31-34 and accompanying text.

102. *See supra* notes 39-55 and accompanying text.

103. *See supra* notes 42-47.

104. *See supra* notes 56-61 and accompanying text.

105. For example, there is still some discretion given to banks in the definition and measure of fair price. Bebchuk & Kahan, *supra* note 9, at 51.

106. Banks still have incentive to retain and attract clients. *Id.* Further, regardless of the restriction on what information management can and cannot give to the bankers, there will always be a potential pro-management information bias. *Id.* at 52.

107. Several commentators have argued for *judicial* approaches to scrutinize the reliability of fairness opinions and their use by directors or management. *Id.* at 46-53; Note, *supra* note 23, at 140-41. The statutory approach offered seeks more to satisfy the interests of special committee directors and shareholders who will rely on such opinions.

108. Ideally, should litigation arise, the statutory approach would deal with several of the problems courts face when relying on a fairness opinion as an indicator of a transaction's "fairness." However, this may be offset by litigation spurned by further legislation giving disgruntled shareholders another "bite" at liability.